E. Existing cable depreciation rates are not radically inconsistent with those prescribed by the Commission for telephone companies.

Given that cable company depreciation rates are very similar to those of regulated telephone companies, rates which telephone companies argue are too low, permitting cable television companies to use those depreciation rates and practices in effect prior to the effective date of the 1992 Cable Act would significantly eliminate undue administrative and regulatory burdens, reflect market realities, and ensure reasonable charges, related to depreciation, to consumers.

1. Cable and telephone company depreciation rates are similar.

Telephone company depreciation rates have been regulated by the FCC and state commissions using traditional rate-setting methodologies. If cable company rates are roughly comparable to those used by regulated telephone companies, this would provide evidence that cable depreciation rates established in an unregulated environment are reasonable. In the previously cited 1986 Ernst & Whinney report, it was found that telephone company depreciation rates in 1985 ranged from approximately 6% to 9%, while cable depreciation rates ranged from approximately 4.25% to 10%. More recent data (see Table 7) from the Group members (1992) and several telephone companies (1991) indicate that telephone company depreciation rates typically ranged from 6.7% (Wisconsin Bell and US WEST) to 7.5% (New York Telephone) with an overall industry average of approximately 6.8%. Rates from a sample of the Group's systems range from 6.4% up to 16.2%, with several clustered around 9%.

TABLE 7

Medium-Sized Operators Group
Cost-of-Service Study

Summary of FYE 12/92 Depreciation Statistics – Cable Companies
($000s)

	Astoria[1]	Las Vegas	Prince William Co.	Rohnert Park	San Angelo[3] (8 months)	South Bay	Syracuse[4]	Tucson	Wisconsin
Depreciation Method	Straight Line	Straight Line	Straight Line	Straight Line	Straight Line	Double[2] Declining Bal.	Straight Line	Double[2] Declining Bal.	Straight Line
Total annual depreciation expense	$571	$13,256	$3,549	$3,190	$719	$3,824	$653	$12,978	$5,623
Total Property Plant & Equipment	$8,951	$144,459	$39,328	$36,830	$10,087	$27,389	$7,538	$80,328	$42,821
Accumulated depreciation	$955	$69,949	$14,331	$14,127	$719	$13,077	$653	$33,256	$13,052
Net Property Plant & Equipment	$7,995	$74,509	$24,997	$22,703	$9,368	$14,312	$6,885	$47,072	$29,769
Total depreciation expense/Total PP&E	6.4%	9.2%	9.0%	8.7%	7.1%	14.0%	8.7%	16.2%	13.1%
Accumulated depreciation/Total PP&E	10.7%	48.4%	36.4%	38.4%	7.1%	47.7%	8.7%	41.4%	30.5%

Source: 12/92 Trial Balance and Operating Statements.

[1]Accumulated depreciation is lower due to system rebuild in 1992.

[2]The company reports book depreciation same as tax depreciation.

[3]The company's assets were purchased in 4/92 and were booked at their fair market value with zero accumulated depreciation. Thus, in this first year depreciation expense equals accumulated depreciation.

[4]The company's assets were purchased in 12/91 and were booked at their fair market value with zero accumulated depreciation. Thus, in this first year depreciation expense equals accumulated depreciation

Summary of FYE 12/91 Depreciation Statistics – Telephone Companies
($000s)

	C&P Tel. Co. of Virginia	GTE Southwest	New York Telephone	Pacific Bell	Southwestern Bell	Wisconsin Bell	United Telephone Northwest	US WEST Communi-cations	Composite RHC and Independents
Total annual depreciation expense	$335,517	$265,032	$1,349,890	$1,687,797	$1,591,188	$177,528	$15,963	$1,701,372	$17,932
Total Property Plant & Equipment	$4,941,028	$3,786,901	$17,991,543	$23,819,178	$24,209,545	$2,647,286	$248,176	$25,303,269	$262,743
Accumulated depreciation	$1,830,043	$1,394,754	$6,836,237	$9,172,997	$9,463,147	$1,008,558	$100,112	$9,098,344	$99,997
Net Property Plant & Equipment	$3,110,985	$2,392,147	$11,155,306	$14,646,181	$14,746,398	$1,638,728	$148,064	$16,204,925	$162,746
Total depreciation expense/Total PP&E	6.8%	7.0%	7.5%	7.1%	6.6%	6.7%	6.4%	6.7%	6.8%
Accumulated depreciation/Total PP&E	37.0%	36.8%	38.0%	38.5%	39.1%	38.1%	40.3%	36.0%	38.1%

Source: 1992 Statistics of the Local Exchange Carriers–For the Year 1991," US Telephone Association.

2. Cable and telephone company depreciation reserves are similar.

   Further, comparing cable company depreciation reserves with those of regulated telephone companies indicates that cable company reserves are within the same range, as a percentage of gross assets, as those of telephone companies. Most telephone company reserve ratios are between 35% and 40%, with an overall industry average of approximately 38.1%. Similar data for the Group showed reserve ratios ranging from approximately 30% to 50%, except in exceptional circumstances as noted in Table 7.

3. Greater diversity in cable depreciation rates is appropriate.

   The fact that cable depreciation rates and reserves display greater diversity than those of telephone companies is not particularly surprising given the different circumstances confronting the two industries. Telephone company depreciation rates have been prescribed by regulators based principally on historical mortality data and survivor curves for a mature industry which followed, until recently, standard plant replacement cycles. Cable companies, however, operating in an unregulated environment, have adapted their depreciation practices to account for their own unique operating circumstances. For example, rates may be increased in anticipation of a system rebuild or upgrade. Also, cable rebuilds and depreciation lives frequently track franchise terms, an element not present in the telephone industry.

4. Special Circumstances

   It is likely that cable operators would only make cost-of-service showings initially (except in exceptional circumstances) and then would adjust their rates in the future based on price caps. Because depreciation rates and reserve levels only become relevant in the context of a cost-of-service study, they should only be scrutinized by the Commission when a cost-of-service study is filed. If an operator filing a cost-of-service study displayed unusual rates (for example, due to a rebuild in progress), these could be "normalized" in the study to reflect more typical operating circumstances. However, the potential need to scrutinize an operator's depreciation rates in these limited and unusual circumstances does not imply that any purpose would be served by adopting any form of depreciation prescription or monitoring for the industry as a whole.

V. Income taxes, computed at statutory rates, should be a permissible cost, regardless of the actual form of ownership of the subject cable system.

A. Background

In its NPRM on cost-of-service regulation for cable operators, the Commission, at footnote 32, has suggested that income tax expense would not be recoverable in regulated cable rates by partnerships, sole proprietorships, and Subchapter S corporations. The Commission's rationale is that "taxes would include only those payable by the business entity."

Many of the industry's and the Group's cable systems are operated as partnerships, and a significant number of cable operators, especially smaller ones, are structured as sole proprietorships or Subchapter S corporations. The failure to permit inclusion of an income tax allowance in cost-of-service for cable operators structured in these fashions:

- does not recognize that the economic activities undertaken by these types of business entities have taxable consequences and result in the payment of federal and, in many cases, state income taxes, in a fashion which is not as neatly distinguishable from taxes imposed on the economic activities of corporations as the Commission assumes;

- is inequitable since it penalizes certain forms of business organization adopted by cable operators in a nonregulated environment without permitting these operators sufficient time to reorganize or restructure in response to the demands of rate regulation; and

- ignores the fact that, in some instances, including one under the FCC's jurisdiction, tax allowances have been permitted for entities organized in these fashions.

Each of these points will be addressed in turn.

B. The tax status of partnerships, sole proprietorships, and Subchapter S corporations is not readily distinguishable from that of a corporation.

1. The Commission's oversimplified either/or approach is inequitable.

The Commission has proposed to deny an income tax allowance based on the fact that partnerships, sole proprietorships, and Subchapter S corporations do not, as business entities, directly incur an income tax liability. Rather, their owners include the results of operations on their individual or corporate tax returns to determine tax liability. The basis for this position appears to be that the tax status of the stockholder or owners should not be a considered in determining the tax expenses allowed a regulated entity, but rather only the tax status of the entity itself. This "either-or"

approach, based on the tax status of only the operating entity, oversimplifies the tax consequences of the economic activities of cable operators.

2. Partnerships owned by corporations closely resemble subsidiaries of holding companies.

   Perhaps the most straightforward example of the inequities created by the either-or approach is in the case of a partnership owned by corporations, a situation which characterizes many Group members. In this case, a partnership tax return, Form 1065, is filed, which shows the results of operations on a tax basis, and is virtually identical to the manner in which results of operations are reported on a corporate tax return, for the partnership as a whole. Individual Schedule Ks for each partner are also prepared, which reflect each partner's proportionate share of the partnership's financial results. These proportionate shares are then reflected on each partner's corporate tax return and create a tax liability in the same manner as do the financial results of each partner's other subsidiaries and operations.

   These circumstances closely resemble those of a wholly owned subsidiary of a holding company that files a consolidated tax return, a situation which characterizes most of the major telephone carriers (e.g., the RBOCs and GTE). In those instances, the subsidiary's tax return is consolidated with those of the holding company's other subsidiaries and a single consolidated return is filed by the holding company. Each subsidiary's tax liability is then netted with that of the holding company's other subsidiaries on the consolidated tax return. The only difference in the case of the holding company arrangement is that each subsidiary records its tax-related transactions on its own books.

   In terms of the impact of the results of operations on the taxpayers' (i.e., the partners in this case and the holding company in the case of a subsidiary corporation) tax liability, the results are the same, only the organizational form differs. The fact that proportionate shares of the results of the partnership's operations are reported by several corporate taxpayers, while those of a wholly owned subsidiary would be reported by only one, does not alter the underlying economic fact that the overall tax liability would be the same in either instance. This similarity in circumstances has been recognized by several regulatory bodies, including the Federal Energy Regulatory Commission (FERC).[8]

3. Sole proprietorship, Subchapter S corporation and partnership taxpayers owned by individuals are different than stockholder taxpayers.

   The situation is somewhat different in the case of sole proprietorships, Subchapter S corporations, and partnerships owned by individuals rather than corporations, in that the results of operations are reported on supporting schedules of, generally, individual, rather than corporate, tax returns. This does not, however, affect the way

[8] Great Plains Gassification Associates, 9 FERC P61.221 (1979).

individual, rather than corporate, tax returns. This does not, however, affect the way in which financial results are reported nor the manner in which a tax liability is incurred except that individual rather than corporate tax rates are applied. Under these circumstances, it would be appropriate to use individual rather than corporate tax rates to develop a tax allowance but not to deny a tax allowance altogether. These circumstances are quite different from those of a stockholder in a corporation who has no direct claim on the corporation's earnings, typically acts as a passive investor, and may or may not receive (and report as income) a portion of the corporation's earnings in the form of dividends, depending on the corporation's dividend pay-out and reinvestment policies.

4. Many factors besides organizational form affect taxes paid.

An alternative, and more realistic, approach to evaluating the tax consequences of a cable operator's activities would be to look at all the income taxes paid on its earnings (i.e., revenues less expenses, other than income taxes). The cable industry, unlike the traditional utility industries which virtually always adopt a corporate form, displays a wide variety of organizational forms and ownership structures, each of which can result in quite different overall tax payments on exactly the same level of earnings. In order to accurately determine the ultimate tax liability of an individual cable operator, at least the following information would be required.

- For cable operators that are partnerships, it would be necessary to determine the taxes paid by the partners. In addition, if those partners are other entities, such as corporations, it would be necessary to determine the tax status of the owners, the shareholders, of those entities.

- For cable operators that are corporations, it would be necessary to determine the tax status of all of their shareholders.

A number of other factors will also reflect the ultimate tax payments generated by a cable operator's earnings. Among these are:

- For shareholders that are corporations, dividends are substantially excluded from taxable income. At least 70% of all dividends received by corporate shareholders are excluded from taxable income by those shareholders.

- For those shareholders that have tax losses, dividends received would be subject to no income tax to the extent that the taxable dividends are less than the tax losses from other activities.

- For those shareholders that are exempt from taxes (such as university trust funds and other tax exempt entities), dividends received would be subject to no income tax.

- For those shareholders that have tax deferred status (such as Individual Retirement Accounts or 401(k) Plans), dividends received would be subject to no current income tax, and the amount of future income tax might be difficult to determine currently.

5. Examples show the variety of tax outcomes, possibly including higher taxes paid by noncorporate operators.

   The Commission's either-or proposal to provide a tax allowance for corporations and deny one to partnerships, sole proprietors, and Subchapter S corporations does not fully reflect the range of potential tax outcomes. (The tax allowance included in regulated cost-of-service is an estimate under any circumstances.) The Commission's proposal would deny a tax allowance to certain entities based solely on their organizational form, ignoring the many other factors that affect tax payments.

   Providing all cable operators a tax allowance, regardless of organizational form, would result in a more accurate and equitable reflection of an operation's actual tax status than the Commission's simple either-or proposal.

   To illustrate the virtually infinite variety of outcomes in terms of ultimate taxes paid that could occur depending on organizational form and tax status of the organization's owners, consider the following, simplified example.

   Two cable operators are identical except that:

   - Operator A is a Master Limited Partnership (MLP), while
   - Operator B is a partnership with two corporations as equal partners.

   In the case of a 50% corporate owner, the dividend exclusion would be 80%. Furthermore, assume that (1) the maximum Federal tax rate for individuals is 40% while the tax rate for corporations is 35%, (2) there are no state or local income taxes, (3) both operators generate revenues less expenses of $100 that will ultimately be subject to taxation, and (4) the income is fully distributed to all ultimate owners.

A few of the virtually infinite range of possible tax payments under this scenario are shown by the following examples:

			Total Tax
Case 1:	Operator A	All MLP unit holders are fully taxable individuals.	$40
	Operator B	Both corporate owners have tax losses.	$0
Case 2:	Operator A	Half of the MLP unit holders are fully taxable corporations with tax-exempt shareholders, and half are fully taxable individuals.	$38
	Operator B	One corporate owner is fully taxable but with tax-exempt shareholders. The other corporate owner has a tax loss.	$18
Case 3:	Operator A	All of the MLP unit holders are fully taxable corporations with fully taxable individual shareholders.	$61
	Operator B	Both corporate owners are fully taxable with fully taxable individual shareholders.	$61
Case 4:	Operator A	All of the MLP unit holders are fully taxable corporations with fully taxable individual shareholders.	$61
	Operator B	Both corporate owners are fully taxable with fully taxable corporate shareholders who have fully taxable individual shareholders.	$64
Case 5:	Operator A	All MLP unit holders are fully taxable individuals.	$40
	Operator B	Both corporate owners are owned by fully taxable corporations with tax-exempt shareholders.	$40

Similar examples, displaying equally wide-ranging ultimate tax consequences, could be constructed for corporations, comparing corporations to partnerships, etc.

The point of these examples is straightforward: form of organization is only one variable which affects the tax consequences of a cable operator's activities, and not always the most important one. As regulators have recognized, the myriad of factors which determine the ultimate taxes paid on a cable operator's earnings would be far too numerous and complex to investigate in a normal rate proceeding. For example, an operating entity, especially a corporation, would be unlikely to know the tax status of all or any of its owners.

C. Denial of any tax allowances would be inequitable given that the cable industry has just become subject to rate regulation.

1. Penalizing rational decision-making is inconsistent with sound regulatory principles.

Under the essentially unregulated environment in which the cable industry has operated since at least 1984, cable operators adopted a variety of forms of organization, including partnerships, sole proprietorships, and Subchapter S corporations, as well as traditional corporate structures, to best meet their corporate, financing, and tax objectives. Operators which adopted noncorporate forms of organization have subsequently taken on debt and entered into a wide variety of legal agreements. If operators had recognized at the time they adopted a partnership or other noncorporate form of organization that they would potentially become subject to cost-of-service regulation and would not be permitted to include income taxes in their cost-of-service, a strong incentive to adopt a corporate form of organization would have existed and likely been acted upon. To now penalize operators for these rational business decisions made under significantly different circumstances would be unfair and inequitable. Winners (corporate operators) and losers (noncorporate operators) would be rewarded or penalized on an essentially random basis, irrespective of their financial needs, tax liabilities, or status as good or bad actors. An essentially random system of rewards and punishments based on organizational form flies in the face of fundamental regulatory principles of fairness, equity, and recognition of factual circumstances.

2. No distinction is made between taxable and nontaxable entities in benchmark rates.

It is worth noting in this context that the Commission does not make any parallel distinction between the so-called taxable and nontaxable entities in its benchmark tables. Rather, all cable operators, regardless of their form of organization, are subject to the same per-channel benchmark rates, which were likely developed based on systems organized in any number of ways. Only when it focuses on cost-of-service regulation (for equipment rates and as an alternative to the benchmark per-channel rates) does the Commission propose to distinguish between operators based on their organizational form, creating an unsupportable asymmetry between these alternative approaches to rate regulation.

3. A suggested transition mechanism, if necessary.

While we believe that the Commission should permit inclusion of a tax allowance, if it chooses to pursue the course suggested in the NPRM, a transition mechanism should be put in place. Under this transition mechanism, operators with noncorporate forms of organization would be permitted to include a tax allowance in their cost-of-service for any filing made within one year after the adoption of cost-of-service regulations. Partnerships comprised of corporations would develop their tax allowance at the corporate tax rate, while partnerships comprised of individuals, sole proprietorships, and Subchapter S corporations would use individual tax rates. This

would give these noncorporate entities sufficient time to restructure their form of organization as a corporation, as well as renegotiate loan agreements and other legal arrangements, in response to the proposed Commission policy. Cost-of-service filings made subsequent to this time would then include or exclude a tax allowance based on the operator's form of organization. This approach would substantially reduce the inequities between corporate and noncorporate cable operators that would occur if the proposed tax policy were adopted from the outset, by enabling operators to restructure to a form more suitable for a regulated environment.

D. Noncorporate entities have been permitted to include tax expense in cost-of-service.

1. Background

There is a remarkable absence of published precedent, either positive or negative, which addresses this issue, likely because most of the regulated entities for which this issue would arise are quite small and the cases involving them are unlikely to be published. A review of *Public Utilities Reports* (PUR), which reports a wide sample of state and federal commission and court cases dealing with regulated utilities, revealed that, since 1963, only two cases, one before the New Mexico Supreme Court and one before the Texas Supreme Court, addressed this issue.

2. Prior Cases Support Granting Sole Proprietors, Subchapter S Corporations and Partnerships Tax Allowances

In *Moyston v. Public Service Commission*, 63 PUR. 3d 522, 1966, the New Mexico Supreme Court overturned a decision of the New Mexico Public Service Commission and a lower court that denied an income tax allowance to a gas company operated as a sole proprietorship. The Supreme Court made three basic arguments in permitting a tax allowance for Moyston. First, the Court found that denial of an income tax allowance would constitute confiscation of property. Second, the Court noted that the Commission's decision would force the company to incorporate regardless of whether sound business decision reasons existed to do so, forcing consumers to provide a tax allowance in any case. Third, the Court distinguished between a utility operated as a sole proprietorship and the position of stockholders in a corporation, noting that a sole proprietorship pays taxes on 100% of taxable income while a stockholder pays only on dividends paid out of after-tax income.

In *Suburban Utility Corporation v. The Public Utility Commission of Texas*, 652 S.W. 2nd 358 (1983), the Texas Supreme Court similarly granted a tax allowance to a Subchapter S corporation. The Court there found that the taxes paid by the shareholders in a Subchapter S corporation are "directly comparable" to those paid by a corporation and that denial of a tax allowance to Suburban Utility would be as capricious as denying inclusion of wages and salaries.

We believe that the Commission is faced with the same set of issues in this context, and, to address the issues raised by the New Mexico and Texas Supreme Courts, that

sole proprietorships, partnerships, and Subchapter S corporations should be granted a tax allowance.

3. NECA permits submission of a tax allowance.

Finally, tax allowances for telephone companies operating as Subchapter S corporations and participating in a National Exchange Carrier Association (NECA) pool, have been permitted to include a tax allowance in their cost studies and submit it to the NECA. These tax allowances are then incorporated into the cost-of-service/revenue requirement underlying the NECA's Interstate Access Tariff filed with and approved by the Commission. Section 3.1 of the NECA's Cost Issues Manual (issued in December 1990) states that "Since Subchapter S corporation shareholders are required to pay income taxes on their earnings from the NECA pool, they are permitted a reimbursable tax amount relative to their actual tax liability." The Manual further states that a Subchapter S corporation is permitted an income tax allowance under the following conditions: When it

"1. demonstrates that a tax liability exists that is accepted by a regulatory body.
2. complies with Part 32 of the FCC rules.
3. submits the appropriate income adjustments to NECA."

The reimbursable tax allowance is, however, developed at the maximum individual tax rate, rather than at the corporate rate. Consequently, the Commission has, at least implicitly, permitted the inclusion of a tax allowance for one form of noncorporate entity—Subchapter S corporations (virtually the only noncorporate form of organization adopted by telephone companies). There is no reason not to accord similar treatment to noncorporate cable operators in developing cost-of-service regulations.

VI. COS procedures applicable to future years should provide a cable operator with an alternative to a full-scale COS showing.

We noted in the Introduction the consensus of economic experts that traditional rate-base/rate-of-return regulation is deficient in many respects. In particular, many experts have observed that the "cost-plus" nature of traditional regulation does not give companies sufficient incentive to minimize costs for a given level and quality of service. The Commission has noted these deficiencies and implemented price cap regulation for AT&T and the LECs, and proposed price caps as the primary method for regulated changes in cable rates over time.

Comments in this proceeding generally agree that price caps should be the primary method of regulating changes in cable rates. Widespread use of price caps will bring several benefits in addition to the obvious one of providing greater incentive for efficiency.

- Under price cap regulation, there will be no need for a uniform system of accounts because the Commission will regulate prices rather than costs.

- If depreciation rates are not an "external cost" in the price cap formula, there is no need for the Commission to prescribe depreciation rates.

- Because price caps will eliminate any incentives to "cross-subsidize" between regulated and unregulated services, the Commission does not need to adopt detailed cost allocation requirements.

There also needs to be a "backstop" procedure for the price cap, in cases where a cable operator incurs unusually high costs that are not recognized either in the initial rates or in subsequent changes for inflation and external costs. If the price cap formula is well designed, the backstop procedure will be limited to a few operators which experience for whatever reasons unusually high costs. If the price cap formula is not well designed to allow reasonable cost recovery for most cable operators, then the backstop will become more widely used and the expected benefits of price cap regulation may not be realized.

The backstop procedures should allow the operator the options of a full cost-of-service showing or a more limited procedure that focuses on the factors that cause the unusually high cost. A full cost-of-service option is necessary for those systems where high costs are distributed throughout the operation and are not limited to one or a few cost categories. This may be the case for high cost geographic regions such as the State of Alaska.

A limited (or "streamlined)" backstop procedure that limits the cost showing to one or more individual factors should permit the operator a great deal of flexibility. The "streamlined" backstop procedure should not be limited to a traditional "cost-of-service" showing, but could also include a demonstration that certain costs are unusually high relative to comparable systems. This flexibility will permit the Commission to develop a rich record of information on cable system cost characteristics that may be used over the next several years to develop more sophisticated backstop approaches for the industry.

Some commenters have suggested that the Commission could gather detailed industry cost data for use by individual companies in justifying their high costs relative to industry averages. We would like to add a word of caution on such an approach. Industry cost data is currently not uniform. Each operator uses a somewhat different account structure, different account definitions, different depreciation rates and different procedures for accounting for assets and expenses between systems, divisions, partnerships, etc. One cannot assume that survey data will yield comparable results for the purpose of rate justification.

The "streamlined" backstop approach should not depend on the collection of uniform, industry-wide cost information. We fear that periodic data collection of this nature will inevitably lead to regulatory requirements for uniform accounting procedures, and more regulatory control of the industry. Such an approach is inconsistent with the objective of limiting the backstop to a few situations where costs are unusually high. Rather, a streamlined backstop procedure should allow a cable operator the flexibility to justify high costs based on the information most suitable to its unique situation.

CERTIFICATE OF SERVICE

I, Magdalene Copp, a secretary of the law office of Ross & Hardies, do hereby certify that I have this 14th day of September, 1993, served by first-class mail, postage pre-paid, a copy of the foregoing "Reply Comments of the Medium-Sized Operators Group" to:

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